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## Some Observations on the Future of Electronic Data Processing

## Inventory Pricing for Changing Economic Conditions

## Earned Surplus after a Quasi-Reorganization

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## Some Observations on the Future of Electronic Data Processing

THEODORE R. PLEIM

(New York Office)

The future of electronic data processing has become a subject of some concern to accountants and business executives who are attempting to evaluate their position with respect to "electronics" in business. They are concerned with such questions as the adaptability of computers to business operations, the risks of obsolescence, the effect on business organization, the problems of human relations. It may be helpful to set down some observations on future developments in this field that seem to the writer to be logical projections of current trends.

### APPLICATION OF COMPUTERS TO BUSINESS DATA PROCESSING

The most immediate development that we can expect is the actual realization of many of the things people have been talking about for the last few years. Except in the case of a relatively small number of companies, the accomplishments in business data processing have so far not kept pace with the volume of talk about them. At first there was much talk about an

impending revolution in business data processing through the use of "giant electronic brains." Since these original extravagant statements in the popular magazines, and even in business journals, there have been many realistic discussions about specific and important applications of electronic data processing systems in various industries. The realization of most of these applications still belongs to the future, but they are knocking at the door right now. During the next two years the number of operating installations of electronic computers devoted to commercial use will multiply many times over.

The installations in the immediate future will generally consist of computer systems as we know them today, systems which are the direct descendants of the computers that were developed originally for scientific and engineering calculations. Perhaps as a reaction to the "giant brain" stories, it has recently been fashionable in some circles to dismiss the entire idea of electronic data processing until computer systems designed specifically for business, or even for specific industries,

are available. There has, however, been significant progress in providing for the great volumes of input and output data characteristically required in commercial applications. Recent developments include very high speed printers, and improvements in tape reading speeds and in the density of recording on magnetic tape. Now under development are some new pieces of equipment which will convert data from punched paper tape to magnetic tape, and vice versa. A card punching printer, fed by magnetic tape, is also being developed.

Future developments in the field of data input promise to be extremely important. Direct sensing of characters without key punching, typing or any other type of handling, is already in operation, but in very narrow and limited applications (the sensing of numbers from traveller's checks, for example). There isn't much doubt that we shall soon see other applications of direct sensing from documents whose format can be controlled by the user. The really exciting developments in this field, however, are the recent indications that research aimed at direct sensing of characters from typed or printed documents generally, will prove to be successful. It now seems quite probable that much business data will someday be fed directly into computers in this manner, although it is not a development that is just around the corner.

But even our existing systems of serial type computers with their associated input and output devices have not been exploited to the full as yet. Each year sees an increase in the number of companies that are thought of as possible users of large-scale computer systems. A few years ago one manufacturer of such equipment considered 50 systems as the maximum that American business could use. At the end of last year that limit had been raised to 5,000 without any firm conviction that it would remain at that figure. A representative of another manufacturer predicts that 10,000 large computers will be in use in this country ten years from now. This indicates that we shall see some medium-sized as well as large businesses making profitable use of large-scale electronic data processing systems in the not-too-distant future.

One reason for this trend is to be found in the increased importance that the "blue sky" approach is likely to attain. The "blue sky" approach refers to the justification of computer systems by reason of the improvement in profits that may be obtained when management receives more timely information, or information it has not previously been practicable to obtain. The reasoning behind this approach applies with equal force to a business of any size. The possibilities in the "blue sky" approach may not be directly measurable in dollars but

may still be very real, and may far exceed the possibilities in clerical cost reduction. There is likely to be increased recognition of this concept in the near future.

In the next few years we can expect an acceleration of the recent trend in the development of intermediate-size and small computers. While some medium-sized businesses in certain industries will acquire large-scale systems, most of these companies will use intermediate types. There will probably be a significant increase in the number of special purpose computers in the next few years. In size, speed and cost, these systems will be similar to the intermediate general purpose computers, but will be designed to handle specialized applications with great efficiency.

#### DEVELOPMENTS IN COMPUTER "HARDWARE"

There will be a gradual reduction in physical size and in the cost of all types of computer systems. The development of transistors and other substitutes for the vacuum tube, will make it possible to build computers that require less space, less power and less air conditioning equipment. The new, and extremely fast, magnetic core memory systems are very costly to construct. They require very careful and laborious wiring of hundreds of thousands of small ferrite cores. But in these days of automation in the factory, it seems reasonable to assume that

some assembly-line technique will be successfully applied to the construction of magnetic core memories before very long. If this assumption is borne out, the resulting reduction in cost may make it economical to use magnetic core memories in intermediate as well as large-scale computers. The resulting increase in the speed of the medium-sized computer systems will, in turn, increase the number of companies that will be able to use them profitably. Cost reduction is definitely in the picture but it will probably take place gradually over a fairly lengthy period.

The development of economical large capacity random access memory systems will have a greater effect on business data processing methods than will any other improvement in the "hardware." A large random access memory would permit the internal storage of entire files of data, and avoid the need of sorting transactions data into a numerical sequence. Transactions could be processed as they occur, in random fashion, and from a number of sources simultaneously.

A good beginning has been made in this field, but much larger and faster random access memory systems are being developed. One such system will have a capacity of 300,000,000 digits of information, any of which would be available in less than one second. It will have the ability of transferring 225,000 digits per second from the memory.

This system will be made possible by extremely dense recording of data on a large magnetic drum. It will be used in connection with a very high speed computer, and will probably be the prototype for one type of random access memory to be used in large-scale computer systems of the future. Other types of random access memory systems are also being developed, one of which features multiple units, each having a capacity of 5,000,000 digits.

The cost of random access memory systems having both large capacity and speed will be quite high, at least in the immediate future. The breakthrough into an entirely new order of electronic data processing systems, based on such memories, must probably wait for something approximating the mass-production of magnetic core memories, or the development of entirely new types of magnetic storage. When the time comes that the cost of large capacity, high speed magnetic storage can be reduced to a reasonable level, we can expect to see a substantial change in the approach to business data processing. This is something that is probably more than a few years away, and not likely to render obsolete any installations planned for some time to come.

\* \* \* \*

In general, the future promises to bring a series of developments that will make electronic computers steadily more effective in processing

business data. Of equal or greater significance is the effect that the use of this new tool of management will have on our ways of doing business.

#### IMPACT ON ORGANIZATION FOR BUSINESS PROCEDURES

There has been a tendency recently to take a much broader view in studying business procedures, to examine an entire business function as it affects all departments. Where we formerly might have surveyed a payroll or a billing operation, we now think it necessary to examine the manpower function from personnel records through payroll distribution, or the sales function from customers' orders through sales analysis and accounts receivable. The objective is to find the best way to perform the function in one integrated procedure, and provide all the data that are required by the company. This tendency toward breaking down departmental lines has been given great impetus by the computer's demand for volume and by its ability to handle integrated rather than piecemeal operations. In the future, computer feasibility studies will be used more and more frequently as opening wedges for the integration of data processing, in many cases the real objective of the systems man.

The trend in business organization today seems to be towards decentralization of management. Some fear that the use of electronic computer systems for data process-

ing is inconsistent with decentralized operations. The solution will frequently lie in the centralization of data processing as a sort of internal service bureau, supplying the information needs of the various decentralized parts of the organization.

Some companies have already decided to adopt this kind of solution, and plan to make their electronic data processing system the heart of a data processing center. For many companies this decision will create a communications problem that may prove as important as the systems analysis and programming problems, or even more important.

The communications problem will probably be relieved to considerable degree by the development of relatively inexpensive communications systems using voice transmission channels. Economical communications systems would not only facilitate the development of data processing centers for companies with decentralized operations, but would also promote the increased use of electronic computer service bureaus by relatively small companies, and those located at a distance from important cities.

Computer service bureaus will become quite popular in the next few years. Various manufacturers of electronic computers are now setting up service bureaus in all the important cities. Later, many independently operated computer service bureaus will be in business.

Perhaps there will be more of them than of the punched card service bureaus of today. Many companies that will not require an electronic data processing system of their own will, however, have certain periodic data processing chores of considerable volume, where speed in obtaining the reports is also important. Here the service bureaus will be able to render a great service. The process of analyzing and programming these chores with the service bureau personnel, will also frequently serve as an education for company personnel in the field of electronic data processing, and help them to determine whether the company could profitably use a system of its own.

We will see a better understanding in the near future of what the computers can do for us, and what they cannot do. It will be more generally understood that a computer system will not be a substitute for the thorough analysis of a problem. Quite the contrary, most businessmen will realize that all the variables of the problem, and their relationships to each other, must be clearly defined and understood before the computers can help. Then, however, the computers will give us accurate and speedy answers, and remove the drudgery from data processing.

#### HUMAN RELATIONS

Finally, we come to the most important question of whether people

are becoming obsolete. Fears have been expressed that the application of computers to data processing will cause serious unemployment problems, create hardship and ill will, and that the office worker will become the slave of an electronic monster. In the future such fears will be mentioned more frequently in the popular press.

Actually, electronic data processing systems that will do the routine work of many clerks will be needed to forestall a serious shortage of adequate clerical help. The productivity of clerical workers has not kept pace with the increasing productivity of our industries, and a continuously increasing ratio of clerical to production workers has been required to meet the information needs of business and government. The computer systems will increase the productivity of our clerical force and partially offset this trend.

Dislocations, even within one company, will not be as troublesome as many now imagine. As the computer system is applied to one procedure, the clerks displaced will be absorbed in other areas where shortages exist, and in the work of applying the computer to other procedures. By the time the electronic data processing program is completely installed, normal attrition will generally have eliminated any surplus of help without any wholesale firings. There will be some problem cases among older

employees, but the large majority of clerks that will be affected are the younger female clerks. They will likely show a willingness rather than resistance to job changes during their relatively short business careers.

As in the case of other technological advances, we can expect the creation of new jobs. A new profession of data processing will come into being to cope with the work of system analysis and design, programming, and debugging of thousands of applications, and later of improving the applications. Moreover, we can now only guess at the new jobs that will need to be done in new areas of useful business information, made practicable through the use of electronics in data processing.

In the future the office workers will have more interesting work to do. Unlike some technological improvements, which had the effect of eliminating the craftsman, the computers will absorb the dull, repetitive routine, leaving to the office people the more varied work of establishing controls, making decisions, and interpreting results.

#### SUMMARY

In summary, it appears that we are entering a period of gradual, but significant, improvements in the application of electronic computers to business data processing. It will be a period of more general under-

*(Continued on page 22)*

## Inventory Pricing for Changing Economic Conditions

BY JOHN J. FOX

The effect of changing economic conditions on accounting policies is a subject that requires continuing attention from the accounting profession. Perhaps no phase of accounting work is more sensitive to changes in business conditions than valuation of inventories. During 1955 many industries achieved peak levels of production. A continuing high level of production has been predicted for 1956, when some believe that gross national product will reach 410 billion dollars. There are some indications, however, of at least a temporarily reversed trend in some fields. The auto industry, for instance, is operating on lower production schedules than a year ago.

A sound, conservative valuation of inventories is important at all times but is of even greater significance when sharp changes in business conditions are in prospect. Such changes frequently cause:

- Changes in tax rates
- Revisions in financial policies
- Changes in product lines and pricing policies.

The accountant in performing his task of appraising inventories and determining their valuation should be alert to possible future changes in

economic conditions. He should also be familiar with the principles of economics which underlie our accounting precepts. For example, underlying our concept of market value is the law of supply and demand which has been stated by the renowned economist, John Stuart Mill, as, "Price is fixed at a margin where the quantity offered is equal to the quantity demanded." A related economic concept which influences accounting policies for inventories is that of utility. Economists have defined different types of utility as form, place and time utility. Each of these is recognized in valuing inventories.

Accountants recognize, as do economists, that value may differ from the cost of production. Accountants have selected as the basic principle of valuation, the lower of cost or market. Although this is a hybrid concept it is useful because it denies:

- Recognition of unrealized profit,  
and
- Deferment of losses.

This is usually stated as the principle of conservatism.

My purpose in introducing these few basic economic principles is to emphasize the interrelationship of

economics and accounting. Any accounting decision that is not sound from an economic or business viewpoint is not sound accounting. The accountant can best approach the question of inventory valuation in times of economic change by directing his attention to fundamentals. While accounting principles for inventory valuation are simple, the application of those principles to diverse factual situations is frequently far from simple. When the underlying economics are clearly comprehended, a correct decision on valuation problems is a probable result.

The fundamental principles for valuing inventories are most authoritatively stated in Chapter 4, *Inventory Pricing*, contained in the Restatement and Revision of Accounting Research Bulletins published by the American Institute of Accountants in 1953. Statement 2 sets forth, "A major objective of accounting for inventories is the proper determination of income through the process of matching appropriate costs against revenues." With that objective in mind, let us examine more closely some of the problems encountered.

#### **COST:**

The primary basis of accounting for inventories is cost. As applied to inventories, cost is understood to mean the cost of acquisition or production. The determination of cost involves consideration of many prob-

lems frequently encountered by the cost accountant. It is well to keep in mind the underlying economic concept of value, since amounts expended which do not add to the value of the product should not be included in inventory cost. Items such as idle facility expense, excessive spoilage, double freight and rehandling costs are examples frequently encountered of expenditures which may not be properly includable in inventory costs. Selling, administrative and general expenses are usually excluded, as not incident to production. On the other hand, transportation and storage charges add place and time utility and should be included.

The flow of cost factors through the accounts is based on assumptions which must be made. The most usual assumptions are:

- Specific identification
- Average
- First in, first out
- Last in, first out.

The objective in selecting an appropriate assumption as to the flow of cost factors is to select the method which under the circumstances most clearly reflects income. Where, for example, the merchandise is customarily accounted for on a specific identification basis, that method should ordinarily be used. An automobile dealer, for instance, can always identify the specific costs of each auto when it is sold or when he takes inventory. He may, how-

ever, find an average or first in, first out costing method more appropriate for his parts inventory.

In its most elementary form, cost of production is composed of material, labor and related manufacturing expenses.

**MATERIAL:**

Material cost is related to the direct material which enters into and becomes a part of the final product as distinguished from supplies used in the manufacturing process which do not become a part of the product and which should be included in manufacturing expenses. Material cost should include the amount paid to a vendor together with any related charges for transportation. Direct material should exclude abnormal spoilage, which should be treated as a current charge to income. Proceeds from the sale of the scrap residue should be credited back to cost.

As a general consideration, material cost should not exceed cost based upon the source of procurement normal to the particular business or industry. Thus, one manufacturer requiring large quantities of steel will normally procure his requirements from a steel mill and pay only mill prices. Another manufacturer requiring relatively smaller quantities of material may find it advantageous to procure his requirements from warehouse sources, paying higher prices. In both cases, the price actually paid is the ap-

propriate measure of cost. Should, however, the manufacturer who normally procures his material from the steel mill, due to poor planning, require an emergency purchase at higher warehouse prices, the premium paid should probably not be included in his product costs since no value has been added to the product through the excess payment.

In periods of scarce supply, materials may not be available from usual sources of supply and may be obtained only from secondary sources at premium prices. This situation existed in the post World War II steel market and disposition of such steel premiums presented a major accounting problem in many large steel processing industries. It seems to me to be appropriate to dispose of such premiums on the basis of their economic implications. In instances where they can be passed on to customers through increased selling prices, it seems to be appropriate to include such premiums as an element of cost, but where such premiums cannot be passed on and have created no economic value, they should be absorbed as period charges.

**DIRECT LABOR:**

The distinction between direct and indirect labor, while important from an analytical viewpoint, is generally not too significant for inventory valuation since indirect labor is includable in inventory as a component of manufacturing ex-

pense. At one time, the terms productive and nonproductive were widely used but were abandoned on the grounds that indirect labor should be considered productive. Labor that is truly nonproductive, such as idle time, rework time, etc., should be excluded from the direct labor accounts. Although a certain amount of such labor may be considered normal and therefore may be included as an indirect inventory cost, any excessive amounts should be absorbed as period charges.

Labor expended on new products or processes may be abnormal in amounts and should be carefully reviewed to determine the extent includible in product cost.

#### MANUFACTURING EXPENSES:

This category of cost is increasing in importance due to the introduction of automatic equipment. Automation usually results in substantially greater proportions of overhead than other costs. Apportionment of expenses between current and future periods in such circumstances requires closer attention on the part of the cost accountant.

In one instance, the president of a company became disturbed at an increase in his overhead rate. On investigation, it was determined that some automatic equipment had been introduced. Increases in the amounts of depreciation, maintenance and other manufacturing expenses resulted while the cost of direct labor remained constant. An

increase in total production also occurred, however. Although the rates of overhead to direct labor did increase, unit cost of production decreased. The net operating profit of this company was entirely satisfactory and the increase in overhead rates was nothing to be disturbed about.

All expenses related to the productive process should be included in product costs. The underlying concept of value should especially be kept in mind as a criterion of whether particular expenses should be included as product costs or absorbed as period charges. For example, the costs of maintaining an idle plant contribute nothing to product value and should be absorbed in the current period. Nor is the value of items produced increased because fixed expenses must be allocated over abnormally small production volume. In practice, an approximately normal volume of production should be determined and overhead should be allocated on the basis of such normal volume. When actual production falls below this normal level, the excess overhead should be considered to be in the same category as idle plant expense and charged to current income as a period charge. However, no more than actual overhead should ever be deferred to future periods through inclusion in inventories.

The allocation of overhead expenses between product lines is a problem that requires the careful

exercise of skill and judgment on the part of the cost accountant. The cost system should be designed to produce an appropriate allocation of burden to different product classes. Consideration should be given to the basis of allocation: labor hours, machine hours, labor dollars, etc., and an appropriate basis selected. The extent of departmentalization, allocation of service departments and other factors must be decided on the basis of the requirements of the product line. When all products pass through the same departments and processes, have approximately the same rate of turnover, etc., an over-all plant rate may be more appropriate than the most intricate system requiring extensive allocations of service department costs. (Although a plant rate may be appropriate for product costing, departmental determination of expenses may still be desirable for purposes of cost control. In such circumstances, complicated service department cost allocations are unnecessary.)

#### **STANDARD COST:**

The use of standard costs does not conflict with the principle of valuing inventories at actual cost. The standards are a means of measuring cost. If they are established at an attainable level and are currently revised to reflect changes in conditions, they should be acceptable for purposes of product cost determination. When ideal stand-

ards established at unattainably low levels are in use, it is usually necessary to allocate variances between inventory and cost of sales.

A properly established system of standards includes in product costs only those expenditures which add value to the product. Standards should be established at normal levels of production, and idle plant costs and other inefficiencies are usually charged automatically to variance accounts.

Substantial variances should always be investigated to determine their effect on inventory valuation. If the standards are current and attainable, variances caused by material spoilage, labor inefficiency and underabsorbed burden should usually remain as period charges. Price variances and overabsorbed burden should usually be allocated between inventory and cost of sales if significant in amount.

I personally feel that a system of standards which is attainable, revised at least annually for changes in conditions, and coordinated with a realistic budget, affords a measurement of cost far superior to that available under any so-called "actual" cost system. However, a hazard of using standards which are not up to date is illustrated in a very recent experience. In reviewing some questions of policy regarding product lines, it was pointed out that selling prices of a particular line were falling dangerously close to their standard cost. On investi-

gation, it was discovered that the standards were quite ancient and had not been revised to reflect introduction of improved processing equipment. In that circumstance, the use of the standard had not only inflated inventory values but had restrained management from promoting a very profitable line.

#### MARKET:

I have stated that the primary objective of inventory valuation is matching costs and revenues and my remarks on cost determination have been aimed at pointing out factors that require special treatment in determining the portion of costs incurred that is to be deferred to future periods as properly related to revenues to be earned in such future periods. A departure from the cost basis is required when the utility of goods is less than their cost due to factors such as physical deterioration, obsolescence, changes in price levels or other causes. Such reductions in value should be recognized as a loss in the current period by marking inventory values down to market when lower than cost.

The Accounting Research bulletin on inventory pricing has established replacement or reproduction cost as the measure of market subject to the limitation that market should not exceed net realizable value, nor should it be less than net realizable value reduced by an allowance for an approximately normal profit margin.

This realizable value limitation is intended to restrict the recognition of inventory losses to situations of actual economic loss. In instances where goods in inventory are committed under firm sales contracts which permit recovery of cost and normal profit, reduction to lower replacement costs would be inappropriate.

Replacement value should usually be considered in terms of the availability of the quantity and quality required in the usual market place. The availability of steel at lower mill prices would not justify the reduction in price of steel inventories of a user who customarily fills his requirements at higher warehouse prices.

The pricing of hops in the brewing industry can illustrate this principle. The *Brewer's Bulletin* regularly carries quotations as to the current market value of hops. In valuing year-end inventories of hops for a large brewer, it was noted that his cost for hops exceeded the current market quotations and a reduction to market was discussed. On investigation, it was discovered that most of the hops crop is contracted for by brewers before it is even harvested. Current market transactions at year-end consisted of small sales of crop remnants which would not be satisfactory in quality nor could the open market produce the quantity required. In the circumstances, no reduction to market was warranted.

A converse situation involved an iron producer who when planning a shutdown of his blast furnace for rehabilitation purchased for foundry use a substantial quantity of pig iron from outside sources at prices higher than his own cost of production. At the completion of the shutdown, a substantial quantity of purchased pig iron remained and was retained in inventory. Due to the cost of rehandling, the newly-produced iron was immediately processed while the purchased iron remained in inventory. It was determined that reproduction cost was a fairer measure of market for the purchased pig iron than the higher quoted public market prices, particularly in view of the fungible nature of this commodity.

In the case of manufactured products, a realizable value can be determined only for finished production. When the realizable value of a finished product is less than its cost, a computation can usually be made of the loss to be incurred on the related work in process and any raw materials committed to the product, through estimating costs of completion. The recognition of such anticipated losses is appropriate.

More difficult questions of valuation sometimes arise in connection with excessive quantities and obsolescence. Replacement cost has little significance in determining the value of obsolete goods, or goods which are held in quantities in ex-

cess of those readily marketable in the immediate future.

Whenever production is discontinued on a line, or when new models are introduced, the estimated realization of the remaining goods must be carefully considered. It is frequently necessary to retain stocks of replacement parts for discontinued models. In such circumstances, the estimated recovery should be reappraised periodically.

In another case of a brewery, a large and apparently permanent decline in sales volume had resulted in the accumulation of a substantial quantity of bottles and cartons in excess of any anticipated usage. On the occasion of a change in stock ownership, it was determined that these items had been carried at full cost for many years. Many of the cartons had not been moved and could not possibly have been shipped out to customers. An estimate was made of the quantity required for operations and the excess cartons were written off as having no realizable value. The excess bottles were reduced to a much lower bulk sale value.

Another interesting case involves a manufacturer of a type of durable equipment which is sold on conditional sales contracts. During the past year, a sizeable inventory of repossessed equipment has been accumulated. There is no ready market for this equipment. As a matter of policy, an effort is being made to sell the equipment at high prices to

purchasers who are unable to obtain financing for cash purchase. In this circumstance the sales actually made are not necessarily a reliable indication of actual market value. An estimate must be made of a fair value that will succeed in merchandising the entire stock in a reasonable period of time.

A final consideration in connection with market value is the question of whether the lower of cost or market should be applied to the inventory as a whole, by classes of merchandise, or to individual items. Any of these three methods is acceptable but sound application of accounting theory will usually indicate that one or another method more clearly reflects income in the particular circumstances. For example, in a manufacturing inventory where a single end product results, the application of the cost or market rule on an over-all basis is probably most appropriate.

Finally, I would like to consider briefly two theories of the application of cost that have been receiving a great deal of thoughtful consideration from accountants in recent years, LIFO and Direct Costing.

#### LIFO:

One problem which has been giving increasing concern to accountants in the field of inventory valuation is the influence of changing price levels. We have been undergoing an inflationary period since 1940 during which time price

levels have increased substantially. One result is that as prices increase, a greater amount of working capital is required to maintain a constant quantity of inventory in terms of physical units. As a corollary, reported income includes an element of inventory profit which can be attributed to economic conditions rather than management effort. This can be simply illustrated by the case of a shoe merchant who maintains a normal stock of 1,000 pairs of shoes of a certain grade. Let us assume that in 1940, this inventory was valued at \$5.00 per unit, or a total inventory valuation of \$5,000. In 1955, this merchant still has an inventory of 1,000 pairs of shoes but the unit value is now \$15.00, and total inventory value is now \$15,000. Obviously, \$10,000 of the amount reported as income by the merchant for the 15-year period is tied up in his inventory which, in a tangible sense, is no greater than it was in 1940. It is doubtful in the true economic sense, that any part of the \$10,000 should be considered as income but in the traditional accounting concept, we report it as income and the merchant is required to pay income tax on it.

The difficulty in this situation lies in the imperfect measuring device we use as a standard of values, that is, money. Economists, in recognition of this situation, attempt to eliminate the influence of inventory profits from their reports

of national income. The Department of Commerce, for instance, has for many years applied a corrective factor for eliminating inventory profits from its reported figures for business income. Accountants also recognize that their art produces an imperfect result when price levels change. The Lifo method of inventory valuation has been devised as one approach to solving this imperfection.

The Lifo method assumes that the flow of costs is such that the unit sold is the unit most recently purchased. This results in earlier low priced purchases remaining in inventory while current revenues are charged with more nearly current costs. In times of rising prices, lower incomes are reported. In times when income is taxed at high rates, the reduction in income taxes resulting from the adoption of Lifo particularly appeals to many businessmen.

Although Lifo generally may result in a better matching of current costs and revenues than is achieved through other acceptable inventory methods, this advantage in income determination may well be accompanied by the presentation of inventory amounts in the balance sheet at less than any fair measure of economic value. To correct such a situation, it has been suggested that Lifo be used in determining income but that inventories be stated in the balance sheet at current value. The difference would be

credited to an account in the capital section of the balance sheet which might appropriately be called "inflation capital." This alternative has some appeal on theoretical grounds, but is not acceptable for federal income tax purposes, nor does it conform to present generally accepted accounting principles.

Incidentally, it is interesting to note that the Lifo method was originally devised for use in industries with large fixed investment in relatively constant stocks of homogeneous nature. Its use has now been extended to many diverse inventory situations including those where the flow of physical units cannot be readily traced. Department stores, for example, are widely using the Lifo method and, in lieu of accounting for actual changes in physical quantity, make use of index numbers (published by the Bureau of Labor Statistics for that purpose) to convert the retail dollar amount of inventory at any date to constant base dollars, and by comparison with the previous inventory at constant base dollars, determine the equivalent of physical quantity changes.

In general, the Lifo method is not suitable for use by companies which acquire inventories only after orders are received and otherwise carry small inventories. The method is most suitable in instances where sales prices are promptly influenced by changes in reproductive costs.

In instances where Lifo is suit-

able, if continuing inflation is anticipated, the tax consequences may make the method very attractive.

#### DIRECT COST:

Another currently popular theory in the field of inventory valuation is that of direct costing. This theory identifies the direct costs of material, labor and overhead as production cost to be absorbed into income in the period in which the product is disposed of through sale, while treating fixed charges, principally establishment expenses, as period charges to be absorbed into income of the accounting period in which incurred. The proponents of this theory offer as its advantages:

1. that it associates reported income more closely with sales
2. that it avoids fluctuation in periodic income due to under- or overabsorption of burden
3. that it recognizes that establishment costs do not vary with production
4. that it is useful as a managerial concept
5. that it keeps inventory values at a minimum.

The assertion is also made with respect to direct costing that operating reports are more useful because they are not influenced by establishment costs over which the present operating management has no control.

In considering the merits of direct costing, we should consider the underlying theory. It is certainly

sound and generally accepted that the cost of producing a product should be associated with the product and absorbed into income in the period in which the product is disposed of through sale. Both the proponents of direct costing and the proponents of all-inclusive costing will readily agree in principle to this thesis. The point of difference arises from the definition of what constitutes cost of production. Accountants have somewhat arbitrarily identified as cost of the product, direct labor, direct material and what is generally understood as manufacturing expense. Such costs exclude selling, administrative and general expense on the ground that those items do not contribute to the production effort. This definition is subject to some criticism. Accountants would certainly recognize business enterprise as one of the prime factors in the production of wealth. From the practical standpoint, an administrative organization is just as essential to the productive effort as many of the costs of the manufacturing organization. The decision to include manufacturing expense in cost and exclude administrative expense is an accounting convention based on general agreement and acceptance. Direct costing advocates, in effect, say that it is no more illogical to distinguish between costs which vary directly with the rate of production and fixed establishment costs than it is to distinguish between manu-

facturing and administrative expenses.

The evaluation of the direct costing proposition should be based on the usefulness of the concept of direct costing. Direct costing can be useful as a managerial concept, and it is entirely appropriate to design the system of internal management reports in whatever method will make them most useful to the users thereof.

While the use of the direct costing method internally may be entirely appropriate, its use externally in published financial statements has not been generally accepted.

Perhaps the most disturbing feature in the discussions of direct costing is the implication that in the absence of direct costing, management is deprived of essential cost analyses. Progressive cost accountants certainly can and usually do produce analytical data in whatever form is most usable to management. Certainly analyses of fixed and variable expenses are widely made. It is also accepted practice to report costs to operating management on the basis of management

responsibility for such costs. It is not at all unusual to report only direct expenses to supervisors who have no control over fixed expenses in companies that have not considered adopting direct costing for inventory valuation.

In conclusion, I would like to summarize my thoughts on inventory valuation in times of economic change:

1. Keep the underlying economic principles firmly in mind.
2. Apply the fundamental accounting concepts of cost and market to the facts of your particular situation in a manner that results in a conservative but fair valuation.
3. Make certain that your cost accounting system produces in a timely manner the information your management requires for controlling costs, establishing pricing policies and planning operations. The management that is adequately informed on these matters will be in a better position to utilize any change in economic conditions to its own advantage.



## Earned Surplus after a Quasi-Reorganization

BY LOUIS H. RAPPAPORT

In accounting the term "quasi-reorganization" means the procedure in the course of which a corporation, without creating a new corporate entity and without resorting to formal court proceedings, is enabled to eliminate a deficit in earned surplus, and to establish a new earned surplus account for the accumulation of earnings subsequent to the effective date of the quasi-reorganization. (The SEC's views regarding quasi-reorganizations are stated in Accounting Series Releases Nos. 15 (1940), 16 (1940), and 25 (1941).)

A quasi-reorganization is not considered by the SEC to have been effected unless all of the following conditions exist:

1. Earned surplus as of the date selected is exhausted;
2. Upon consummation of the quasi-reorganization no deficit exists in any surplus account;
3. The entire procedure is made known to all persons entitled to vote on matters of general corporate policy, and the appropriate consents to the particular transactions are obtained in advance in accordance with law and charter provisions;
4. The procedure accomplishes with respect to the accounts substantially what might be accomplished in a reorganization by legal proceedings—namely, the restatement of assets in terms of present condi-

tions as well as appropriate modifications of capital and capital surplus, in order to obviate so far as possible the necessity of future reorganizations of like nature.

Reductions in the carrying value of assets at the effective date may not be made beyond a point which gives appropriate recognition to conditions which appear to have resulted in relatively permanent reductions in asset values. A procedure of this kind should not be employed recurrently but only under circumstances which would justify an actual reorganization or formation of a new company. Full disclosure of the quasi-reorganization should be made in the financial statements for the fiscal year involved, and all subsequent statements of surplus should designate the point of time from which the new earned surplus dates.

The question arises ultimately: how long must the "dating" of subsequent earned surplus be disclosed? There comes a time when the fact of a dated earned surplus account has little, if any, significance. In the case, for example, of a company which wrote off a deficit of \$1,000,000 in 1932, and since that date has accumulated \$25,000,000 of earned surplus, the fact that earned surplus is "since 1932" is a matter of no importance.

In financial statements prepared for management or for inclusion in reports to stockholders, some public accountants have continued to disclose the dating until, in their opinion, that fact has lost its significance. Thereafter the earned surplus account is described as just that—earned surplus, with no additional language to indicate the point of time from which it accumulates.

The Research Department of the AIA studied this question in connection with its continuing survey of published financial statements of 600 corporations. The results of that study are interesting in that they reveal how the dating disclosure is eliminated from published statements with the passage of time. The following table shows the results of the AIA study:

<i>Date from Which Earnings Accumulated</i>	<i>Number of Cases</i>			
	1954	1953	1952	1951
1925-1927.....	1	1	1	1
1928-1930.....	1	1	1	1
1931-1933.....	6	7	10	14
1934-1936.....	12	16	17	21
1937-1939.....	14	14	16	17
1940-1942.....	7	7	7	9
1943-1945.....	4	5	6	6
1946-1948.....	1	2	2	2
1949-1951.....	1	1	1	1
1952-1954.....	1	1	1	1
	—	—	—	—
	48	55	62	73
	=	=	=	=

The table discloses that in 1951, for example, there were 14 companies which indicated that their earned surplus accounts represented accumulations since 1931-1933. In 1952, the number of such companies was reduced to 10, in 1953 to 7, and in 1954 to 6. In their filings with SEC, however, all companies were required to date their earned surplus accounts for an indefinite period.

In February, 1956, the AIA Committee on Accounting Procedure issued Accounting Research Bulletin No. 46 in which it stated that the dating of earned surplus following a quasi-reorganization would rarely, if ever, be of significance after a period of ten years. The Committee further stated that there may be exceptional circumstances in which the discontinuance of the dating of earned surplus could be justified at the conclusion of a period of less than ten years. We understand that the views expressed in that bulletin are, in general, shared by the SEC, although the Commission reserves the right to consider other periods of time as appropriate with respect to discontinuance of dating of surplus in the light of specific circumstances. We do not view the SEC's position as constituting a qualified assent of the AIA bulletin, since the bulletin itself seems to deal with ordinary cases in which the dating disclosure has no significance.

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## The Prize-Winning Articles for 1955

The firm is pleased to announce the winners for the best articles by a staff member published during 1955 in *The Journal of Accountancy* and in the L. R. B. & M. JOURNAL. The selections are made by well-qualified persons not connected with our organization, and are as follows:

### THE JOURNAL OF ACCOUNTANCY:

First Prize—\$1,000. Awarded to R. K. MACLEOD for his article entitled "Percentage Depletion Controversy."

Second Prize—\$500. Awarded to LEONARD F. BECKERS for his article entitled "The Audit of Cash."

### THE L. R. B. & M. JOURNAL:

First Prize—\$1,000. Awarded to LAMBERT H. SPRONCK for his article entitled "Today's Costing Methods and Their Objectives."

Second Prize—\$500. Awarded to CARL J. SIMON for his article entitled "Reducing Paper Work Costs."

As announced in the October-December 1955 issue of the L. R. B. & M. JOURNAL, beginning with the year 1956, prizes will also be awarded in similar amounts for articles written by members of the staff and appearing in the *N. A. C. A. Bulletin*, official publication of the National Association of Cost Accountants.

**The L. R. & M. Journal**

Published by Lybrand, Ross Bros. & Montgomery, for distribution to members and employees of the firm.

The purpose of this journal is to communicate to every member of the staff and office, plans and accomplishments of the firm; to provide a medium for the exchange of suggestions and ideas for improvements; to encourage and maintain a proper spirit of cooperation and interest, and to help in the solution of common problems.

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ROBERT S. WARNER	Los Angeles
WILLIS K. WATERFIELD	Cincinnati
HARRY C. ZUG	Philadelphia

## Editorials

### James F. Sanborn, Jr.

With great sorrow we report that James Farrington Sanborn, Jr., partner of our Boston office, died without warning during the evening of January 26, 1956. He was beloved and respected by all his associates and by the many clients he served. His buoyant personality and his industrious, able contribution to the services of our firm will be keenly missed for many years.

Mr. Sanborn was 49 years of age and had devoted his whole career to the practice of public accounting with our firm. After attending Mount Hermon School, he entered Dartmouth College, receiving the A.B. degree in the Class of 1928 and the degree of M.C.S. from The Amos Tuck School.

He leaves his wife, Alice MacGuinness Sanborn, and three children, Carol Ann, Stephanie and James F. III.

Mr. Sanborn was an ardent golfer and angler, but in addition to his family the great enthusiasm of his life was his profession, which he practiced with complete honesty, sound judgment and devotion to the standards of our firm.

### Leonard Raum Honored

The Board of Directors of the Tax Executives Institute unanimously resolved that Honorary Membership in the Tax Executives Institute be presented to Leonard Raum, of our Washington office. His gold membership card was presented at the Institute's midyear conference in Washington, February 26, 1956. The honorary membership, the seventh to be presented, was given to Mr. Raum in recognition of his many contributions in the interests of the Institute, and the unsparing talent and energy which he had devoted to furtherance of the aims of the Institute.

## Some Observations on the Future of Electronic Data Processing

*(Continued from page 6)*

standing of the prerequisites and limitations in using the electronic systems. The era of the pioneers is closing, the coming ten years or so will be the period of widespread application of electronic systems of all sizes and types to all sizes and types

of business. Any business organization not already engaged in studying the application of electronics to its data processing problems had better get started now or run the risk of suffering a competitive disadvantage.

## Notes

### Birmingham Office

Mr. Anthony J. DiIenno participated in a tax panel session on February 23, presented over Station WBRC by the Birmingham Chapter of N.A.C.A.

Mr. Leon L. Palmer has been appointed to serve on the Management Services Committee of the Alabama Society of Certified Public Accountants.

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### Boston Office

Members of the Quarter Century Club of the Boston office and supervisory members of the staff were guests of the partners at a luncheon on December 23, at the Union Club of Boston. Mr. Sidney B. Heywood was presented a gold watch, suitably inscribed, in recognition of his twenty-five years association with the Boston office. There are now 16 active members of the Quarter Century Club in this office.

Mr. Charles V. McCue has received his Massachusetts C.P.A. Certificate.

Mr. Kendall B. Murray is teaching "Hospital Accounting" at Northeastern University in the Evening Division.

Mr. Elmer A. Oesterlin has been appointed to the Finance Committee of the Town of Natick.

Mr. Stuetzer has recently had the following speaking engagements:

"Depreciation Under the '54 Code," on November 5, 1955 before the Fall River Chapter of the N.A.C.A.

"Recent Tax Developments," on December 20, 1955, before the North Shore Chapter of the N.A.C.A., and on January 19, 1956, before the Worcester Chapter of the N.A.C.A.

"Valuation of Capital Stock for the Massachusetts Corporation Excise," at the Northeastern University Institute of Taxation, in Boston, on February 4, 1956.

"Depreciation Under the '54 Code," at the Harvard Law School Senior Tax Seminar on February 21, 1956.

In addition, on November 17, 1955, Mr. Stuetzer acted as Chairman of the morning session on "Taxation of the Operating Business" at the New York University Institute of Federal Taxation.

On February 25, 1956 he participated with a life insurance man and two members of the bar in the presentation of a one-act play dealing with estate planning before the annual Winter meeting of the Massachusetts Bar Association at Worcester.

In December of 1955 he became Chairman of the State Affairs Committee of the Greater Boston Chamber of Commerce.

On January 17, 1956 he was elected to the Board of Directors of the Granite Trust Company, Quincy, Massachusetts.

**Detroit Office**

The following partners and staff members are serving in the capacities indicated for various organizations for the year 1955-56:

**MICHIGAN ASSOCIATION OF CERTIFIED PUBLIC ACCOUNTANTS**

P. G. Righter:  
Board of Directors

J. J. Fox and T. Kinden:  
Committee on Accounting and Auditing Procedure

Linn W. Hobbs, Vice-Chairman and  
N. A. Bolz:  
Committee on Relations with Bankers

H. F. Spengler:  
Committee on Relations with Educators

John McCullough and L. J. Wilson:  
Committee on Federal Taxation

D. M. Russell:  
Committee on Legislation

C. J. Code:  
Committee on Personnel

K. P. Schechter:  
Graduate Study Conference Committee

W. R. Richards:  
Public Relations Committee

L. H. Homan and N. S. Peters:  
Publications Committee

**NATIONAL ASSOCIATION OF COST ACCOUNTANTS**

J. J. Fox:  
Team Captain

L. J. Wilson:  
Associate Director of Publicity

M. G. Hierlihy and E. W. Reynolds:  
Members of Reception Committee

Mr. Fox addressed the Dayton Chapter of the National Association of Cost Accountants on January 17, 1956 on "Inventory Pricing For Changing Economic Conditions."

Mr. Code addressed the Detroit Council, National Tool & Die Manufacturers' Association on September 19, 1955 on the subject, "Good Accounting Can Help You Stay In Business With Today's Competition."

Messrs. John Loughlin and Howard Sweet passed the C. P. A. examinations in May, 1955 and have received Michigan certificates. Mr. Howard Morba has received a certificate of examination.

Mr. Jerome Halperin passed the Michigan Bar examination and has been admitted to practice in the State of Michigan.

Mr. Harry Henderson retired from active service on September 30, 1955. He had served as head bookkeeper at the Detroit office, his original employment being in 1942.

Mr. L. J. Wilson participated in panel discussions between officials of the Internal Revenue Service and the National Association of Cost Accountants on Radio Station WWJ on February 27 and March 5.

Messrs. Eldin H. Glanz, Robert L. Pobur, Ralph E. Kandt, and L. Vlahantones have passed the November, 1955 C. P. A. examinations and have received Michigan certificates. Edward Bolle has received a certificate of examination.

**Louisville Office**

Mr. Harold W. Glore spoke to the National Machine Accountants Association, Falls City Chapter, on

January 19, 1956. The title of his talk was, "The Auditor's View Toward Machine Accounting, Its Installation, and The Audit of Machine-Kept Records."

Mr. Curtis J. French, speaking on "Selling Internal Auditing to Management," addressed the Institute of Internal Auditors, Louisville Chapter, on January 24, 1956.

Mr. W. R. Hindman, on January 17, 18 and 19, 1956, attended the Moraine Farm Program on Machine Accounting, sponsored by The National Cash Register Company, Dayton, Ohio.

Messrs. Thomas K. Baer, William D. Wagner, and Earl B. Wiggins, Jr., having successfully passed the November, 1955 C. P. A. examination, were presented their certificates at the February meeting of the Kentucky Society of Certified Public Accountants, and have been admitted to membership in the Kentucky Society. Mr. L. S. Sorbo introduced the speaker at the presentation dinner.

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#### Rockford Office

Mr. Myers is serving as a member of the Admissions Committee of the Illinois Society of Certified Public Accountants for 1955-56.

Mr. Tinkham spoke to the Northern Illinois Chapter, Illinois Society of Certified Public Accountants, on March 22, 1956. His subject was "Accounting for Pension and Profit-Sharing Plans."

Mr. Lonnie L. Webb has been awarded his Illinois C. P. A. certificate, based on the November, 1955 examination.

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#### New York Office

Mr. Richardson spoke at the New York Chapter Tax Executives' Institute on February 7, 1956 on "Accounting Theory and Accounting Problems in Taxation." On February 21 he addressed the Birmingham, Ala., Chapter N.A.C.A. on "Current Tax Developments."

At the Annual Dean's Day Homecoming Conference of the New York University Graduate School of Business Administration, February 25, Mr. Bardes talked on "Incentive Compensation with Tax Savings to Employer," and Mr. T. R. Pleim was moderator of the session on electronic systems and spoke on "The Promise for the Future."

Mr. William Morris addressed the Albany, N. Y., Chapter N.A.C.A. on March 20, 1956. His subject was "Capital Asset Accounting after a Year of the New Internal Revenue Code."

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#### Philadelphia Office

Mr. Mahon was a member of the Federal Income Tax Problems Panel of the Institute of Newspaper Controllers and Finance Officers in New York City on September 27, 1955, and spoke on the evaluation of newspaper shares.

He also filled the following speaking engagements:

Federal Tax Clinic of the Alabama Society of Certified Public Accountants at the University of Alabama, Tuscaloosa, Alabama, on October 28, 1955, on the subject "Current Problems Affecting Methods of Accounting Under the 1954 Code."

Stradley Tax Luncheon Group in Philadelphia on November 18, 1955, on "Current Commentary on 1954 Code."

Joint dinner meeting of the Delaware Accountants Association and the Delaware Society of Certified Public Accountants, November 22, 1955, in Wilmington, on "Current Tax Developments."

The Philadelphia Control of the Controllers Institute on January 5, 1956, on "The 1954 Revenue Code—One Year Later."

The following N.A.C.A. Chapters on the dates and subjects listed:

- Jan. 18—Brooklyn, "Current Commentary on the 1954 Code"
- Feb. 8—Delaware, "The Effect of Current Tax Law on Business Decisions"
- Feb. 15—Pittsburgh, "What's New in Taxes for 1956."

Mr. Hewitt served as Chairman at two technical sessions of the Philadelphia Chapter of the National Association of Cost Accountants—first, the annual discussion forum on November 29, 1955, on the subject "Pricing for Competi-

tion," and, second, at the regular technical meeting of the Chapter on December 15, 1955, on "Federal Tax Planning." He is a member of the Conference Committee arranging the Philadelphia Regional Conference of N.A.C.A. to be held April 6-7, 1956 of which the general topic will be "Management Accounting in Action."

Mr. Petty spoke before the Thirteenth Annual Philadelphia Accounting Forum at Temple University on November 15, 1955 on the subject "What to Expect in Public Accounting"; he also addressed the Accounting Club of the University of Delaware on the same subject on December 16, 1955.

Mr. Zug was a member of a panel at two meetings sponsored by the Philadelphia Chapter of the Pennsylvania Institute of C.P.A.'s which were held in Allentown on October 17, and in Philadelphia on November 7, 1955, on the subject "Current Problems in the Valuation of Inventories." On March 9, he spoke at the Episcopal Academy, Philadelphia, on the subject "Public Accounting as a Career."

Mr. Raymond E. Graichen spoke on "Administrative Procedures in Federal Income Tax Disputes" at the opening tax meeting of the Philadelphia Chapter of the Pennsylvania Institute of C.P.A.'s on October 3, 1955.

On December 10, 1955, he addressed the Northeastern Chapter of the Pennsylvania Institute of

C.P.A.'s on "Gift and Estate Taxes" at Wilkes College, Wilkes-Barre, Pa.

Mr. Herman C. Heiser made several addresses on the subject "Streamlining Accounting Procedures for Automation," as follows:

Sept. 20, 1955—Houston Chapter N.A.C.A.

Nov. 8, 1955—Executive Club of the Boston Chamber of Commerce

Dec. 9, 1955—Lehigh Valley Chapter of N.A.C.A. at Easton

Dec. 12, 1955—Williamsport Chapter of N.A.C.A.

Jan. 11, 1956—Wilmington Chapter of N.A.C.A.

He also addressed the New Hampshire Chapter of N.A.C.A. on October 18, 1955, on the subject "Direct Costing."

Mr. James E. Meredith, Jr., spoke before the Baltimore Chapter of the Systems and Procedures Association on December 12, 1955, his topic being "How to Make a Survey for Equipment Installations."

Mr. Harold C. Hunsberger served on the committee for the Annual Discussion Forum of the Philadelphia Chapter, National Association of Cost Accountants, held at the Hotel Sylvania, Philadelphia, Pa., on November 29, 1955.

Mr. Edward F. Habermehl addressed The Philadelphia Credit Women's Club on February 9 on "Individual Federal Income Taxes."

Mr. Lewis A. Martorano has been admitted to membership in the

National Society for Business Budgeting. At a meeting of the Society's Philadelphia Chapter on February 20, he was a member of a panel which discussed "Budgeting for Capital Expenditures."

The following members of our staff have been admitted to membership in the Philadelphia Chapter of N.A.C.A.:

Russell K. Crans

Thomas E. Heney, Jr.

John A. McConnell, Jr.

Richard J. Niederriter

Charles S. Vogan

Frederick J. Wonsetler

Mr. Robert A. Paczulla has been elected to membership in the American Institute of Accountants.

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### Pittsburgh Office

Mr. Bower has been appointed to the Pittsburgh Business Show Committee for a six-year term. The Committee sponsors a business show bi-annually at which more than one hundred business equipment firms display their products.

Mr. James E. Gelbert spoke on "Individual Income Taxes" before the Erie N.A.C.A. Chapter on January 23, 1956, and before the Beechview Lions' Club on February 22, 1956. He also spoke before the Tax Executives' Institute in Pittsburgh on February 23, 1956, on the subject of "Rulings under the 1954 Code." Mr. Gelbert is a mem-

ber of the Planning Committee, Pennsylvania Institute of Taxation, 10th Annual Conference to be held at the Pennsylvania State University in May, 1956.

Mr. Ralph P. Kulzer is a member of the Planning Committee, 2nd Annual Accounting Study Conference sponsored by the Pennsyl-

vania Institute of C.P.A.'s and Pennsylvania State University.

Five staff members of the Pittsburgh office were successful in passing the C.P.A. examination in November, 1955:

John V. Davidson	James M. Ganley
John W. Heastings	Walter A. Lowe
Thomas J. O'Reilly	



